88-1238

NO.

Supreme Court, U.S.
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# In The Supreme Court of the United States

OCTOBER TERM, 1988

CLEMON J. and IVY C. HERRINGTON
Petitioners

VERSUS

COMMISSIONER OF INTERNAL REVENUE
Respondent

---

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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## QUESTIONS PRESENTED

1.

Whether the duty of consistency doctrine estops a taxpayer from relying on a decision of the United States Tax Court to disavow gains from a straddle transaction, where that Tax Court decision holds such straddles to lack economic substance for purposes of gains or losses, and where the statute of limitations bars adjustment of a loss deduction previously claimed by the taxpayer on a different leg of the same straddle?

2.

Whether the failure of a taxpayer to appeal a Tax Court determination that his straddle transaction was a sham constitutes a change of position for purposes of the duty of consistency doctrine?

3.

Whether the Court of Appeals exceeded its authority in affirming the decision of the Tax Court, on estoppel grounds, without inquiring as to whether the Commissioner had proved each element of the duty of consistency?

## LIST OF PARTIES TO PROCEEDING

PETITIONERS-APPELLANTS

Clemon J. Herrington
Ivy C. Herrington

RESPONDENT-APPELLEE

Commissioner of Internal Revenue

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## OPINIONS AND ORDERS BELOW

The opinion of the United States Tax Court in *Glass v. Commissioner,* 87 T.C. 1087 (1986) involves a consolidated case which includes the petitioners' case; the *Glass* opinion is reported at 87 T.C. 1087 (1986). The individual decision of the Tax Court finding a deficiency in petitioners' income tax is unreported and included in the appendix at A.

The opinion of the United States Fifth Circuit Court of Appeals is reported as *Herrington v. C.I.R.,* 854 F. 2d 755 (5th Cir. 1988), and included in the appendix at B.

The Order of the United States Court of Appeals for the Fifth Circuit denying petitioners' Petition for Rehearing is unreported and is included in the appendix at C.

## JURISDICTION

The Order of the Clerk of the United States Court of Appeals for the Fifth Circuit dismissing petitioners' appeal from the decision of the United States Tax Court was entered on September 13, 1988. The Order of the Court of appeals denying petitioners' Petition for Rehearing was entered November 1, 1988. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. Sec. 1254 (1), 28 U.S.C. Sec. 1651, and 26 U.S.C. Sec. 7482 (a).

## FEDERAL STATUTES INVOLVED

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## STATEMENT OF THE CASE

Beginning in 1976, petitioners, Clemon J. and Ivy C. Herrington, (hereafter "taxpayers") entered into a series of straddle transactions

through the London Metal Exchange. The "straddles" involved the taxpayers' simultaneous acquisition of rights to sell ("puts") and rights to buy ("calls") silver in that commodities market. Straddles are extensively discussed in *Glass v. Commissioner,* 87 T.C. 1087 (1986) under the heading "Findings of Fact."

The first straddle was established in 1976 and "closed out", through liquidation of the taxpayers' position in the market, in 1977. In 1976, the taxpayers reported and deducted a $60,244.00 loss from the 1976 "leg" of this first straddle. In 1977, the taxpayers reported a $54,231.00 gain from the second leg of the first straddle.

The second straddle was initiated in 1977 (leg 1) and closed out in 1978 (leg 2). A $60,040.00 loss corresponding to leg 1 of the second straddle was reported and deducted on the taxpayers' 1977 return. A gain of $59,686.00, realized when the taxpayers closed out the second straddle, was reported as a long term gain on the taxpayers' 1978 tax return.

On July 3, 1980, following an audit of the taxpayers' 1977 and 1978 tax returns, the Commissioner of Internal Revenue assessed a deficiency of $32,417.57 against the taxpayers for the tax year 1977. This deficiency was calculated on the basis of disallowing the taxpayers' 1977 loss resulting from leg 1 of the second straddle. At the time of the actual I.R.S. audit, the statute of limitations had foreclosed that agency's review and any possible challenge of the taxpayers' 1976 return and the loss deduction, from leg 1 of the first straddle, reflected on that return. See 26 U.S.C. Sec. 6501 (a), reproduced at Appendix E. It is unclear, however, whether the agency had timely classified for examination the taxpayers' 1976 return, and then, through negligence or inadvertence, permitted the statute to run.

On February 9, 1981, the I.R.S. Appeals Office issued a Notice of Deficiency affirming the deficiency as assessed by the examining agent.

On May 7, 1981, the taxpayers petitioned the United States Tax

Court for a redetermination of the deficiency for 1977, alleging alternatively that: 1) the straddles were not shams as the I.R.S. contended, that is, transactions lacking a profit motive; and 2) elimination of the loss deduction from the 1977 return, if proper, would require elimination or "excision" of the 1977 gain resulting from leg 2 of the first straddle.

The Tax Court ordered the taxpayers' case consolidated with over a thousand other cases involving substantially the same issues, and assigned to the taxpayers Docket Number 9926-81. On November 17, 1986, the Tax Court rendered its opinion in the consolidated cases under the name *Glass v. Commissioner*, 87 T.C. 1087 (1986). The Tax Court held in *Glass* for the Commissioner of Internal Revenue, stating as follows:

> "In conclusion, we hold that the London Option Transaction--petitioners' multiple and complex tax straddle scheme encompassing prearranged results--lacked economic substance and was a sham. Petitioners consequently may not deduct the losses claimed by them in Year One of their straddle transactions. It follows, of course, that since the straddle transactions were a sham, gains reported by petitioners in Year Two and thereafter do not constitute taxable income to them, and we so hold."

87 T.C. at 2811 (emphasis added). See also 26 U.S. C. Sec. 165(c) (2), reproduced at Appendix D.

On May 14, 1987, the Tax Court issued an individual decision affirming the deficiency as assessed by the I.R.S. on the taxpayers' 1977 return. Neither the text of the *Glass* opinion nor the individual decision issued in the taxpayers' case makes reference to detrimental reliance by the Commissioner on any representation made by the taxpayers in 1976. Nor was any evidence, to taxpayers' and undersigned counsel's knowledge, presented by the Commissioner relative to his detrimental reliance on the taxpayers' 1976 representations.

Subsequent motions by the taxpayers to revise the individual decision, on the basis that it failed to account for the taxpayers' 1977 gain, which the *Glass* opinion clearly declared to be non-taxable, were denied without assignment of reasons.

The taxpayers appealed to the United States Court of Appeals for the Fifth Circuit, arguing that they should be allowed to avail themselves of the holding in their own case (*Glass* ) and have their 1977 deficiency recalculated after excision of the 1977 gain. The Fifth Circuit affirmed the decision of the Tax Court, reasoning that, since the taxpayers had represented in 1976 that they had suffered losses from bona fide transactions, and since 1976 was then closed by the statute of limitations, the duty of consistency doctrine estopped the taxpayers from claiming that the 1977 leg of the first straddle was non-taxable.

Petitioning for a rehearing, the taxpayers urged that the Court of Appeals had erred in the following particulars: 1) The Fifth Circuit's opinion ignored the "same fact or transaction" principle embodied in the first and third elements (discussed infra) of the duty of consistency doctrine; 2) The Fifth Circuit erroneously determined that the taxpayers' failure to appeal the "sham transaction" holding of *Glass* constituted a change of position regarding the bona fides of a transaction reported in a statute-barred year; 3) The Fifth Circuit failed to hold the Commissioner to his burden of proving the estoppel theory on which he relied; and 4) The Fifth Circuit assumed, on the basis of a silent record, that the taxpayers had greater access to the facts surrounding the London Metal Exchange straddles than did the Commissioner.

On November 1, 1988, the Fifth Circuit entered a per curiam order denying the Petition for Rehearing. This Petition for Writ of Certiorari follows.

## FEDERAL JURISDICTION OF THE COURTS BELOW

I. The United States Tax Court's jurisdiction to review the deficiency assessed by the Commissioner was conferred by 26 U.S.C.

Sec. 6214 (a) and 26 Sec. 7442.

II. The United States Court of Appeals for the fifth Circuit had jurisdiction to review the Tax Court's decision pursuant to Section 7482 (a) of the Internal Revenue Code of 1954.

## REASONS FOR GRANTING THE WRIT

The duty of consistency, or "quasi estoppel" doctrine was formulated to deter taxpayer abuse of the statute of limitations, which limits to three years the Internal Revenue Commissioner's time for assessing tax deficiencies. The doctrine in essence forces the taxpayer to report in consistent fashion an item or transaction originally reported in a statute-barred year. To cite a simple example: a taxpayer who inherits property in year one, and declares its value at one dollar ($1.00) for estate tax purposes, is estopped from claiming, after the statute of limitations expires for year one, that the true value of the property was one hundred dollars ($100.00). Such recharacterization might be attempted when the taxpayer, in the year he sells the property, desires to limit for tax purposes his gain from the sale. Under the duty of consistency, it would not matter that the original reporting of the property's value at $1.00 could be proven erroneous. See, e.g., *Beltzer v. United States*, 495 F. 2d 211, 212 (8th Cir. 1974).

Properly understood, the duty of consistency represents a departure, based on equity, from the strictures of the statute of limitations; the doctrine allows the Commissioner of Internal Revenue to look back to an otherwise statute-barred year to determine whether the taxpayer has, from a closed year to an open year, inconsistently treated the same item or transaction. *Orange Securities Corporation v. Commissioner of Internal Revenue*, 131 F. 2d 662, 663 (5th Cir. 1942). As an equitable doctrine, the duty of consistency should, in the name of judicial restraint, be sparingly applied, and only in well-defined circumstances.

The taxpayers here had argued in the Fifth Circuit that forcing the facts of this case into the duty of consistency doctrine would not only stretch the doctrine out of recognizable shape, but also represent a dangerous expansion of the Commissioner's power to evade the three year statute of limitations.

The facts of this case do not fit the doctrine for several reasons: first, the taxpayers did not change their position with respect to "an

item or transaction," totally separate from the item (the 1976 loss) arising from the 1976 transaction (leg 1 of the first straddle).

The Commissioner, through references to "the 1976-1977 straddle transaction," persuaded the panel of the Fifth Circuit that the straddle was but one integrated transaction, so that the taxpayers' argument that the 1977 gain was non-taxable appeared inconsistent with the loss reported in 1976. This "integration" approach was specifically rejected in *Smith v. Commissioner*, 78 T.C. 350, 385-90 (1982), which ruled that separate legs of a straddle are *separate* transactions.

Not only did the Fifth Circuit erroneously integrate the separate 1976 and 1977 transactions, it also failed (as did the Tax Court) to recognize that the taxpayers were at all times advancing — not inconsistent positions — but alternative arguments; that is, the taxpayers had argued in the alternative that either 1) the straddle transactions were bona fide, and resultant losses were deductible; or 2) if the straddles were deemed lacking in economic substance, then the resultant gains as well as losses should be lifted from the 1977 return.

The Tax Court adopted this latter, alternative argument in its *Glass* opinion, but refused without explanation to apply it to the taxpayers' individual case.* The Fifth Circuit attempted a rationalization of the Tax Court's individual decision by: 1) citing the duty of consistency doctrine; 2) ignoring the Fifth Circuit's holding in *Orange Securities, supra*; 3) ignoring the Tax Court's rejection of the integration approach in *Smith v. Commissioner*, 78 T.C. 350 (1982); and 4) ignoring the principles underlying estoppel cases in the First Circuit (*Moran v. Commissioner*, 67 F. 2d 601 (1st Cir. 1933), *Portland Oil Company v. Commissioner*, 109 F. 2d 479 (1st Cir. 1940)), the Tenth

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* While a taxpayer's option and right to advance alternative arguments with impunity have been oft-reaffirmed (see I.R.S. Private Letter Ruling 8340002; *See also Dobson v. United States*, 330 F. 2d 646 (Ct.Cl. 1964)), the Fifth Circuit's opinion below announces that a taxpayer advances alternative arguments at his peril. The Fifth Circuit has, in effect, adopted the Tax Court's *Glass* holding (taxpayers' alternative argument) only to the extent that it disallows straddle losses, and rejected the *Glass* holding (taxpayers' main argument) only to the extent that it treats straddle gains as non-taxable.

Circuit *(C.I.R. v. Farren* ) 82 F. 2d 141 (10th Cir. 1936); *Doneghy v. Alexander, Collector* 118 F. 2d 521 (10th Cir. 1941)), and the Sixth Circuit *(Crosley Corporation v. United States,* 229 F. 2d 376 (6th Cir. 1956)).

The facts do not fit the estoppel doctrine for a second reason: the taxpayers' alleged "change of position" did not relate to a transaction originally reported in a *statute-barred* year (1976), but to such a transaction originally reported in a *still-open* year (1977). One never-changing element (the third) of the duty of consistency doctrine has been that the taxpayer changes his position, with respect to the original item or transaction, in a year after the statute of limitations bars adjustment to the transaction originally reported in the statute-barred year. The only transaction under review, since straddle leg 1 (1976) cannot be integrated with straddle leg 2 (1977), (see *Smith, supra p. 7)* is leg 2 of the first straddle (1977), reported in a still-open year. This situation is to be contrasted with the factual patterns of, for example, *Beltzer* and *Orange Securities, supra,* which concerned respectively the non-reporting of gains from sales in statute-barred years and the valuation of stock inherited for estate tax purposes in a statute-barred year.

Thirdly, the facts of this case do not fit the duty of consistency doctrine because the alleged change of position occurred, reports the Fifth Circuit, by virtue of the taxpayers' failure to appeal the "sham transaction" component of the Tax Court's holding. The most that should be read into the taxpayers' failure to appeal the merits of *Glass* is that the taxpayers exercised their right not to appeal on the expectation that the Commissioner would be required to consistently apply the holding to all 1977 straddle transactions, both those resulting in gains as well as those resulting in losses. To equate failure to appeal a lower court's decision with acquiescence in the court's findings is unwarranted.

An incidental difficulty with the Fifth Circuit's opinion, apart from it's misconception of the estoppel doctrine elements, is that it presumed without any offer of proof that the Commissioner had detrimentally relied on taxpayers' representations in a closed year

(1976). This burden properly lies with the Commissioner, not the taxpayer. *Southern Pacific Transportation Company v. Commissioner,* 75 T.C. 497 (1980).

Taxpayers appreciate that the function of the United States Supreme Court, in exercising its jurisdiction, is not to correct errors of law committed by a lower court, or to resolve conflicts between decisions rendered by different panels of the same appellate court, or to consider merely interesting or novel issues, or even to review evidence.

The Supreme Court's jurisdiction should, however, be exercised to prevent continued erosion of the three year statute of limitations applicable to tax cases. The duty of consistency doctrine itself was formulated to relax the harshness of result which an unswerving adherence to the statute of limitations can produce. When exceptions are created to relax the elements of an already equitable (i.e., extra-statutory) doctrine, the Commissioner's capacity to evade his responsibility to efficiently and timely administer the federal tax laws is ominously enhanced.

In *Rothensies v. Electric Storage Battery Co.,* 329 U.S. 296 (1946), this Court refused to allow an equitable doctrine to take precedence over the statute of limitations. The Court recognized that the statute of limitations serves an essential function in the tax law; that its integrity must be preserved; and that it can only be overridden in exceptional circumstances.

Writing for the *Rothensies* Court, Mr. Justice Jackson stated in part (at page 302):

> "As statutes of limitations are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayers and losses to the revenues may be pointed out. They tempt the equity-minded judge to seek for ways of relief in individual cases."

Despite the cautionary note sounded in *Rothensies*, the federal

courts developed the duty of consistency doctrine as a means of preventing abuse of the statute of limitations. To allow the courts to further weaken the statute of limitations, through liberal application of the extra-legal duty of consistency doctrine, would constitute serious and inappropriate erosion of the limitations Congress has imposed on the Commissioner's power to collect taxes.

This case thus merits a discretionary exercise of jurisdiction due to the importance of the first issue involved. But the Supreme Court should also intervene because the Fifth Circuit has sanctioned a significant departure by the Tax Court from the accepted and usual course of judicial proceeding; it is unusual indeed for a taxpayer to move the Tax Court to declare his gains to be non-taxable (the *Glass* decision) and then witness the same Tax Court, in the same proceeding, affirm a deficiency based in part on those same non-taxable gains.

Next, this Court should exercise jurisdiction in order to announce with specificity the particular elements of the duty of consistency doctrine.

Neither the Commissioner, the instant taxpayers, nor the courts below were able to cite United States Supreme Court decisional law which squarely endorses the positions taken by either side, though the Supreme Court's general approval of equitable tax doctrines is reflected in *R.H. Stearns Company v. United States,* 291 U.S. 54, 54 S. Ct. 325, 78 L.Ed. 647 (1934), in *Bull v. United States,* 295 U.S. 247, 55 S. Ct. 695, 79 L.Ed. 1421 (1934), and more recently in *Hillsboro National Bank v. Commissioner,* 460 U.S. 370, 103 S. Ct. 1134, 75 L.Ed. 2d 130 (1983). As a result, the various circuits have been left free for the last half century to formulate the duty of consistency on their own. Not surprisingly, some differences have emerged.

The Fifth Circuit's first articulation of the doctrine, inspired by *Stearns, supra,* was simply: "The fact fixed for one year ought to remain fixed in all its consequences, unless a more general settlement is proposed." *Alamo National Bank v. Commissioner of Internal Revenue,* 95 F. 2d 622 (5th Cir. 1938). Later, the Fifth Circuit an-

nounced the doctrine with somewhat more specificity: "[A] taxpayer may not, after taking a position in one year to his advantage and after correction for that year is barred, shift to a contrary position touching the same fact or transaction." *Orange Securities Corporation v. Commissioner of Internal Revenue,* 131 F. 2d 662 (5th Cir. 1942).

Citing *Orange Securities,* the Sixth Circuit invoked the doctrine adding:

> "As pointed out by this Court in *Robinson v. Commissioner,* supra, in order for the doctrine of estoppel to be applicable the taxpayer by his conduct must knowingly make a representation or conceal a material fact which he intends or expects will be acted upon by taxing officials,... and the true or concealed material facts are unknown to the taxing officials, or they lack equal means of knowledge with the taxpayer, and act on his representation or concealment[.]"

*Crosley, supra* (citations omitted).

In *Beltzer v. United States,* 495 F. 2d 211 (1974), the Eighth Circuit, inspired by *Stearns, supra, Alamo, supra,* and the Tax Court in *McMillan v. United States,* 64-2 U.S.T.C. par. 9720 (S.D.W. Va. 1964) announced the three elements of the quasi-estoppel or duty of consistency doctrine as follows: 1) the taxpayer has made a representation or reported an item for tax purposes in one year; 2) the Commissioner has acquiesced in or relied on that fact for that year; and 3) the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessments bars adjustments for the initial tax year. To undersigned counsel's knowledge, the Tenth Circuit has not enumerated separate, specific elements of the doctrine. Instead, its estoppel decisions in the tax area simply cite *Stearns, supra,* for the rule that no one may profit by his own omission. *See, e.g., Doneghy, supra,* and *Farren, supra.* But analysis of the fact patterns in those two cases reveals that the Tenth Circuit has, like the Eighth Circuit, (and, indeed, the Fifth Circuit in *Orange Securities* ) found estoppel to lie where the taxpayer attempts to change a position with respect to an item or transaction originally

reported in a *statute-barred* year, a principle ignored in the instant case.

Whether the Fifth Circuit below erred or not, its articulation of the doctrine is subtly but critically at variance with the Eighth Circuit's *Beltzer* test, on which the Fifth Circuit purports to rely: The Fifth Circuit states: "The elements...are: 1) a representation or report by the taxpayer; 2) on which the Commission [sic] has relied; and 3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner." *Herrington v. C.I.R.*, 854 F. 2d 755, 758 (5th cir. 1988), citing *Beltzer, supra, Crosby Corporation, supra*, and *Joplin Brothers Mobile Homes, Inc. v. United States,* 524 F. Supp. 800, 803 (W.D. Mo. 1981).

The taxpayers in this case would have prevailed in the Eighth Circuit under the *Beltzer* test. Their alleged "change of position" related to an open, not a statute-barred year. Further, element one of the doctrine as announced in *Herrington* simply requires "a representation" by the taxpayer, as opposed to representation of *an item* for tax purposes in *one year* as required under *Beltzer*. This seemingly minor difference in phraseology leads to a drastic difference of result, for the "item" in a now statute-barred year here is leg 1 of the 1976 straddle, with regard to which the taxpayers make no representation at all. Further, the Fifth Circuit's broad reading of element one (a "representation or report by the taxpayer") allows a court to ignore the Tax Court's rule against "integration," *supra* p. 7).

This Court in *Hillsboro, supra*, recently announced a formulation of the "tax benefit rule," a relative of the duty of consistency, which formulation now stands as a guide to the lower federal courts. Certiorari should be granted in this case to announce the correct formulation of the duty of consistency doctrine, as well as to consider the soundness of the Fifth Circuit's evolving notions of the doctrine's elements.

Finanly, jurisdiction should be exercised to consider whether the

Fifth Circuit exceeded its review authority in applying a doctrine (on the basis of a largely silent record) which, because of its extra-statutory nature, should be sparingly applied.

## CONCLUSION

For the foregoing reasons, the petitioners, Clemon J. and Ivy C. Herrington, respectfully request that this Court issue a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit.

Respectfully submitted,

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# APPENDIX A

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

Entered: May 14, 1987

| | | |
|---|---|---|
| CLEMON J. and IVY C. HERRINGTON, Petitioners | * | LONDON OPTION CASE |
| | * | Docket No. 9926-81 |
| VERSUS | * | |
| COMMISSIONER OF INTERNAL REVENUE, Respondent | * | |

## DECISION

Pursuant to the determination of the Court, as set forth in its Opinion filed November 17, 1986, it is

ORDERED and DECIDED: That there is a deficiency in petitioners' income tax for the taxable year 1977 in the amount of $32,417.57.

/s/ Arthur L. Nims, III
Arthur L. Nims, III
Judge

## APPENDIX B

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

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NO. 87-4770

---

CLEMON J. and IVY C. HERRINGTON,
Petitioners-Appellants

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee

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APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

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(September 13, 1988)
REHEARING DENIED NOVEMBER 1, 1988

Before KING and JOHNSON, Circuit Judges.

LITTLE, District Judge*

JOHNSON, Circuit Judge:

Taxpayers appeal a Tax Court decision upholding gain on the second half of a "straddle" transaction adjudged a sham by the Tax Court in a companion case. Because we hold that the "duty of consistency" doctrine estops the taxpayers from relying on the sham transaction holding, we affirm.

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* District Judge of the Western District of Louisiana, sitting by designation.

## I. BACKGROUND

From 1976 through 1978, Clemon and Ivy Herrington carried out a series of "straddle" transactions on the London Metal Exchange. These transactions made use of futures contracts pairing "put options" (rights to sell) and "call options" (rights to buy) in such a way as to produce a loss in one year and a gain in the following year. The straddles offered the taxpayer the advantage that the loss in the first year could be deducted as an ordinary loss, but the gain in the second year could be reported as capital gain and taxed at a lower rate than the corresponding loss.

On their 1976 tax return, the Herringtons reported and deducted a $60,244 loss from the first leg of a London Metal Exchange straddle. In 1977, the Herringtons reported a $54,231 capital gain corresponding to the 1976 loss. Also in 1977, the Herringtons reported and deducted $60,040 as the first leg of a second straddle. The Herringtons' 1978 tax return reported a capital gain of $59,686, closing out the second straddle transaction.

The Internal Revenue Service (IRS) audited the Herringtons' 1977 and 1978 tax returns, but allowed the statute of limitations period to expire on their 1976 tax return. Finding the 1977 to 1978 straddle to be a sham transaction without economic substance, the Service assessed a deficiency. The IRS Appeals Board affirmed the deficiency. The Herringtons petitioned for a redetermination to the United States Tax Court, and that court consolidated their case with more than a thousand other cases involving London Metal Exchange straddles. *Glass v. Commissioner,* the consolidated case, found that the type of straddle transaction engaged in by the Herringtons and the other taxpayers on the London Metal Exchange was a sham and had no real economic purpose other than tax avoidance. 87 T.C. 1087 (1986). Specifically, the Tax Court stated:

> In conclusion, we hold that the London Option Transaction - petitioners' multiple and complex tax straddle scheme encompassing prearranged results - lacked economic substance and was a sham. Petitioners consequently may not deduct the losses

> claimed by them in Year One of their straddle transactions. *It follows, of course, that since the straddle transactions were a sham, gains reported by petitioners in Year Two and thereafter do not constitute taxable income to them,* and we so hold.

87 T.C. at 2811 (emphasis added). The Tax Court then determined that the Herringtons owed a deficiency of $32,417.57 in the 1977 tax year, attributable to the 1977 capital gain leg of the 1976-1977 straddle. It is this first straddle that is the subject of the instant appeal by the Herringtons.

## II. DISCUSSION

The Herringtons argue that because the Tax Court has held that both the gains and losses in the London Metal Exchange straddles "lacked economic substance," the court cannot, without contradiction, treat their 1977 straddle gain as real and tax it. The Herringtons acknowledge that they received a loss deduction for the first leg of the same straddle in 1976, but they point out that the IRS cannot undo this loss deduction because the statute of limitations has run on the 1976 tax year. While the Herringtons admit that some inequity would result if they were allowed to deduct the 1976 loss without reporting the corresponding 1977 gain, they argue that this inequity is inherent in any statute of limitations.

[1] Of course, the IRS has not technically violated the statute of limitations, since its gain characterization affects the 1977, not the 1976 tax year. More importantly, the Herringtons are precluded from raising the sham transaction argument by a type of estoppel developed in tax cases, known as "quasi estoppel" or the "duty of consistency." The Supreme Court has long held that general principles of estoppel apply in tax cases. *R.H. Stearns Co. v. United States,* 291 U.S. 54, 54 S. Ct. 325, 78 L.Ed. 647 (1934); *Magee v. United States,* 282 U.S. 432, 51 S. Ct. 195, 75 L.Ed. 442 (1931). The duty of consistency is a doctrine that prevents a taxpayer from taking one position one year, and a contrary position in a later year, after limitations period has run in the first year. *Union Carbide Corp. v. United States,* 612 F. 2d 558, 566, 222 Ct. Cl. 75 (1979); *Beltzer v. United States,* 495 F. 2d 211

(8th Cir. 1974); *Mayfair Minerals, Inc. v. C.I.R.*, 456 F. 2d 622 (5th Cir. 1972); *Crosley Corp. v. United States*, 229 F. 2d 376, 380-81 (6th Cir. 1956); *Johnson v. C.I.R.*, 162 F. 2d 844 (5th Cir. 1947); *Joplin Bros. Mobile Homes, Inc. v. United States*, 524 F. Supp. 800, 803 (W.D. Mo. 1981).

For example, in *Beltzer*, the taxpayer inherited stock, had the stock valued, and paid estate taxes on that value. Several years later, after the statute of limitations had run, the taxpayer sold the stock, had its value at the time of acquisition recalculated, and claimed the recalculated, higher value as his basis. The court held the taxpayer to his original, lower basis. *Beltzer*, 495 F. 2d at 212-13. Similarly, in *Mayfair Minerals*, the taxpayer had accrued and deducted refunds to be paid to its customers. 456 F. 2d 622. Later, after the statute of limitations had run, the taxpayer learned that it had not been liable for the refunds. The I.R.S. characterized this event as the extinguishing of a liability, equivalent to realizing taxable income. The taxpayer argued that the liability had not really existed in the earlier year, and, therefore, there had been no extinguishing of income in the later year. This Court held that the taxpayer was bound by its characterization of the liability in the earlier year. *Id.* at 623.

[2] The elements of the duty of consistency are: 1) a representation or report by the taxpayer; 2) on which the Commission has relied; and 3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner. *Beltzer*, 495 F. 2d at 212; *Crosley Corp.*, 229 F. 2d at 380-81; *Joplin Bros.*, 524 F. Supp. at 803. If this test is met, the Commissioner may act as if the previous representation, on which he relied, continued to be true, even if it is not. The taxpayer is estopped to assert the contrary.

[3] The requirements for estoppel have been met in the instant case. First, the Herringtons filed a tax return for 1976 claiming a deduction on the first leg of the 1976 to 1977 straddle. By claiming this deduction, the Herringtons represented to the Commissioner that the straddle had economic substance. Second, the Commissioner relied

on this representation of the Herringtons by accepting their 1976 return and allowing the statute of limitations to run. Third, the Herringtons now argue, contrary to their previous representation, that the straddles were in fact a sham and that the gain realized in 1977 was not real, taxable income.

Of course, the Herringtons' subsequent inconsistent representation was forced on them by the Tax Court when that court held, in *Glass,* that the London Metal Exchange straddles lacked economic substance. However, the Herringtons did not appeal that holding. The Herringtons have now adopted the *Glass* case as their sole argument against their 1977 tax deficiency. Hence, the Herringtons *now* assert that the London Metal Exchange straddles were shams.

Finally, the Herringtons argue that the duty of consistency does not apply when the inconsistency concerns a pure question of law and both the taxpayer and the Commissioner had equal access to the facts. This is correct. *Mayfair Minerals, Inc.*, 456 F. 2d at 623; *Crosley Corp.*, 229 F. 2d at 380; *Joplin Bros.*, 524 F. Supp. at 803. However, the economic substance of the London Metal Exchange straddles was clearly a question of fact, or at best a mixed question of fact and law, concerning which the taxpayers had more information than the Commissioner at the time the initial representations were made.

To summarize: although the Tax Court has found that the London straddle transactions engaged in by the Herringtons were sham transactions, the Tax Court was also entitled to find that the Herringtons realized real gain on one of these transactions in 1977. The duty of consistency doctrine estops the Herringtons from disavowing their characterization of the transaction as real on their 1977 tax return.

AFFIRMED.

**APPENDIX C**

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

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NO. 87-4770

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CLEMON J. and IVY C. HERRINGTON
Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

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APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

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ON PETITION FOR REHEARING
(November 1, 1988)

Before KING and JOHNSON, Circuit Judges, and LITTLE*, District Judge.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby **DENIED.**

## APPENDIX D

26 U.S.C. Section 165. Losses.

(a) **General Rule.** There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

. . . . . .

(c) **Limitation on losses of individuals.** In the case of an individual, the deduction under subsection (a) shall be limited to

. . . . . .

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business[.]

## APPENDIX E

26 U.S.C. Section 6501. Limitations on assessment and collection.

(a) **General rule.** Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.